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4 UNITED STATES BANKRUPTCY COURT  
5 NORTHERN DISTRICT OF CALIFORNIA

6 In re

7 NUESTRO HOSPITAL, INC.,

No. 02-11128

8 Debtor(s).  
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10 JEFFRY G. LOCKE, Trustee,

11 Plaintiff(s),

12 v.

A.P. No. 02-1176

13 ASPEN STREET ARCHITECTS, INC.,

14 Defendant(s).  
15 \_\_\_\_\_/

16 Memorandum of Decision  
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18 Prior to its Chapter 7 bankruptcy, debtor Nuestro Hospital, Inc., operated a community hospital  
19 in Healdsburg, California. In this adversary proceeding plaintiff Jeffry Locke, the Chapter 7 trustee,  
20 seeks to avoid as a preference a payment of \$75,000.00 to defendant Aspen Street Architects, Inc.  
21 (“ASAI”) twelve days before the bankruptcy. The principal issue is the applicability of the earmarking  
22 defense.

23 In the year 2000, the debtor had hired ASAI to design a new emergency room, incurring a debt of  
24 about \$87,000.00. The debtor sought funds to pay this debt from the Healdsburg Hospital Foundation  
25 (“HHF”), a nonprofit corporation organized to solicit funds for the debtor’s hospital. On January 10,  
26 2001, HHF gave the debtor \$80,969.20 for the express purpose of paying ASAI. However, the debtor

1 used these funds for other purposes and ASAI remained unpaid.

2       On May 15, 2001, HHF gave an other \$100,000.00 to the debtor in response to the debtor's  
3 request for funds for seismic upgrades to the hospital. They were deposited into the debtor's general  
4 bank account. The debtor did not use these funds as intended either.

5       Almost a year later, the debtor was in on the verge of its bankruptcy. By this time on of HHF's  
6 directors, Dr. Dan Rose, was also CEO of the debtor. He knew that the debtor was going to file a  
7 bankruptcy, that ASAI had never been paid (it had sued the debtor and obtained a default judgment) and  
8 was therefore not going to release its designs, that the new entity being formed to operate the hospital  
9 would need the designs, and that the debtor still had some money in the bank. He therefore transferred  
10 \$75,000.00 from the debtor's bank account to ASAI on April 25, 2002 and on May 6, 2002, the day  
11 before the bankruptcy filing, signed an agreement on behalf of the debtor whereby the debtor paid ASAI  
12 \$75,000.00 in return for the designs and satisfaction of the default judgment. The agreement was clearly  
13 made in anticipation of the bankruptcy.

14       The payment was made from a general bank account, not a trust account. It was made on account  
15 of an antecedent debt, and enabled ASAI to receive most of what was due to it and far more than it  
16 would have received had the payment not been made and it received payment pursuant to the provisions  
17 of the Bankruptcy Code. The trustee therefore seeks to avoid the payment pursuant to  
18 § 547(b) of the Code.

19       ASAI has raised three arguments in its defense. First, it argues that by forbearing on collection  
20 of its judgment and agreeing to a lesser sum it gave new value to the debtor, and therefore recovery is  
21 barred by § 547(c)(1). Second, it argues that its release of the designs was new value under the same  
22 section. Third, it argues that the funds paid to ASAI were "earmarked" by HHF for ASAI. The court  
23 finds no merit in any of these arguments.

24       "New value" is defined in § 547(a)(2) of the Bankruptcy Code. The definition does not  
25 encompass forbearance from collecting or compromise of old unsecured debt. *In re Powerline Oil Co.*,  
26 59 F.3d 969, 974 (9<sup>th</sup> Cir. 1995); *In re JWJ Contracting Co., Inc.*, 287 B.R. 501, 508 (9th Cir.BAP

1 2002); *In re Air Conditioning, Inc.*, 845 F.2d 293 (11<sup>th</sup> Cir. 1988), *cert. den.* 488 U.S. 993. Moreover,  
2 all parties knew that the debtor was about to file a Chapter 7 bankruptcy petition; there was no actual  
3 forbearance at all.

4 A party asserting the new value defense must prove the specific measure of the new value,  
5 measured at the time of the transfer. *In re JWJ Contracting Co., Inc.*, at 507. All parties knew that the  
6 designs of ASAI were utterly worthless to the debtor, as it was about to file a Chapter 7 petition and go  
7 out of business. The debtor's estate was clearly depleted by the payment to ASAI. The new value  
8 defense is grounded in the principal that it cannot be invoked where the estate has been depleted. *In re*  
9 *JWJ Contracting Co., Inc.*, at 506.

10 Relying on *In re Superior Stamp & Coin Co., Inc.*, 223 F.3d 1004 (9<sup>th</sup> Cir. 2000), ASAI argues  
11 that it has a defense under the "earmarking" doctrine. That reliance is misplaced for several reasons.

12 Firstly, the doctrine applies when a third party *lends* money to a debtor for a specific purpose.  
13 *Superior Stamp & Coin*, 223 F.3d at 1008; *In re Kemp Pacific Fisheries, Inc.*, 16 F.3d 313, 316n2 (9<sup>th</sup>  
14 Cir. 1994). In this case, the evidence established that HHF *gave* money to the debtor, not loaned it.  
15 Moreover, the funds given by HHF were not used for the purpose specified by HHF when it gave the  
16 money; the first gift of \$80,969.20 was supposed to be used to pay HHF but was not; the second gift of  
17 \$100,000.00, which ASAI argues was eventually the source of payment to it, was supposed to be for  
18 seismic upgrades and not designated specifically for ASAI.

19 Secondly, under *Superior Stamp & Coin* the key inquiry is control of the funds. "If the debtor  
20 controls the disposition of the funds and designates the creditor to whom the monies will be paid  
21 *independent of a third party whose funds are being used* in . . . payment of the debt, then the payments  
22 made by the debtor to the creditor constitute a preferential transfer." 223 F.3d at 1009 (emphasis in the  
23 original). In this case, the debtor had complete control of the funds and could have used them for any  
24 purpose. In fact, it had used the first gift of \$80,969.20 for other purposes. Since it had complete  
25 control of the funds, its payment to ASAI was preferential under *Superior Stamp & Coin* even if that  
26 case is somehow applicable to gifts.

1 Thirdly, ASAI has not proved that the money paid to it was the same money HHF gave to the  
2 debtor. All it proved was that HHF gave the debtor \$100,000.00 about a year before the payment and  
3 that a year later the debtor had about the same amount in its bank account. Dr. Rose, testifying for both  
4 the trustee and ASAI, testified that the funds were impossible to trace. "Policy reasons support a tracing  
5 requirement as a prerequisite to application of the earmarking doctrine." *In re Sierra Steel, Inc.*, 96  
6 B.R. 275 (9<sup>th</sup> Cir. BAP 1989).

7 For the foregoing reasons, plaintiff shall have judgment as prayed, including prejudgment interest  
8 and cost of suit. This memorandum constitutes the court's findings and conclusions pursuant to FRCP  
9 52(a) and FRBP 7052. Counsel for plaintiff shall submit an appropriate form of judgment forthwith.

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13 Dated: April 15, 2003  
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Alan Jaroslovsky  
U.S. Bankruptcy Judge